Infomail
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OIL and the Slippery Slope

"It's not a matter of what is true that counts but a matter of what is perceived to be true."
Henry Kissinger, Nobel Peace Prize Recipient

The biggest news for global markets and global consumers happened on the US Thanksgiving in a far off desert kingdom. Saudi Arabia took on a big gambit of not cutting production which put downward pressure on oil prices, in the short term at least, and that means a lot less cash flow for them as well as the rest of their OPEC partners.

So why would a nation that derives 90% of their revenue from oil allow the price to collapse?

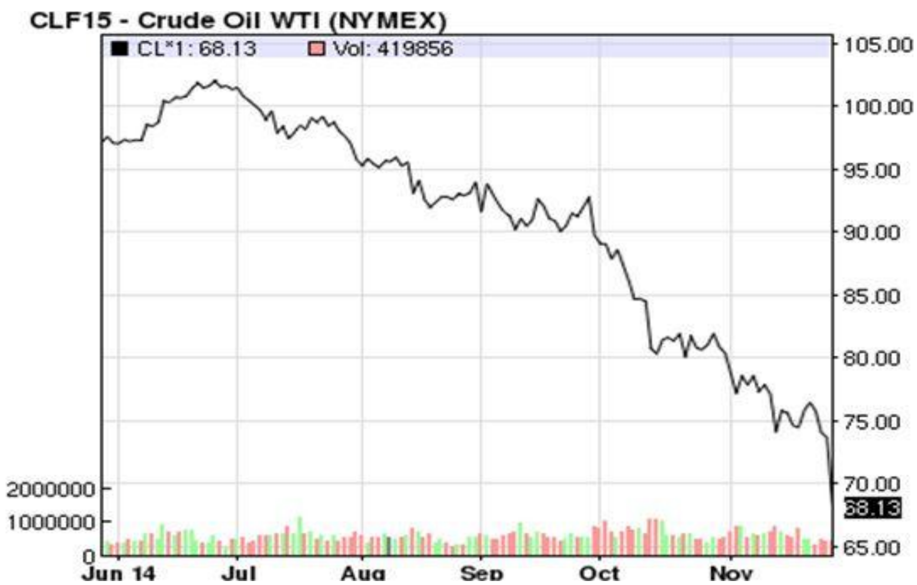
While it can be argued slowing economic demand out of Europe, China and even South America has created some oversupply, I think the velocity of the drop implies there's more to it and it's politically driven than supply/demand economics.

Make no mistake; it's a war without bullets……and on several fronts.

First and foremost, the Saudi's are testing the US fracking miracle. According to the Wall Street Journal, the Eagle Ford Region is the only drilling region still able to be profitable with oil prices hovering at four year lows around $67 USD per barrel:

Drilling Region	Breakeven Begins
Permian Basin	$75
Bakken	$75
Eagle Ford	$65
Mississippi Lime	$83
Texas Panhandle	$81
Niobrara	$78
Scoop	$91
Tuscaloosa Marine	$86

The pace of the most recent sell off is mind boggling:



Huge winners in the fracking story have had to deal with a 40% collapse in pricing in but 60 days. The tradeoff for most Americans is worth more than a few jobs in North Dakota, the argument has always been lower oil prices mean lower prices at the pump which means more disposable income in the consumers' pockets to spend or invest elsewhere.

Maybe the Saudi's are simply rethinking their commitment to play a role in balancing world markets? Short term swings in demand and supply have always caused fluctuations, but in recent years, Saudi Arabia adjusted production to keep the market balanced and prices fairly stable.

At the November 27th OPEC meeting, Saudi officials suggested it may no longer be willing to cut supply to balance weaker demand and US supply growth. But it won't be forever in my opinion.

Past energy cycles have shown if prices remain under US $80 for sustained periods, it has a huge impact on activity and investment very quickly which can be significant given the recent drop, but it will sow the seeds of future oil price spikes.

Some (including myself) think the spectacular price decline in crude was orchestrated by the Saudi's in helping the USA humble the Russian bear, hurt Putin where it counts most, and in the meantime hurt Iran, ISIS and socialist nations Venezuela and Bolivia.

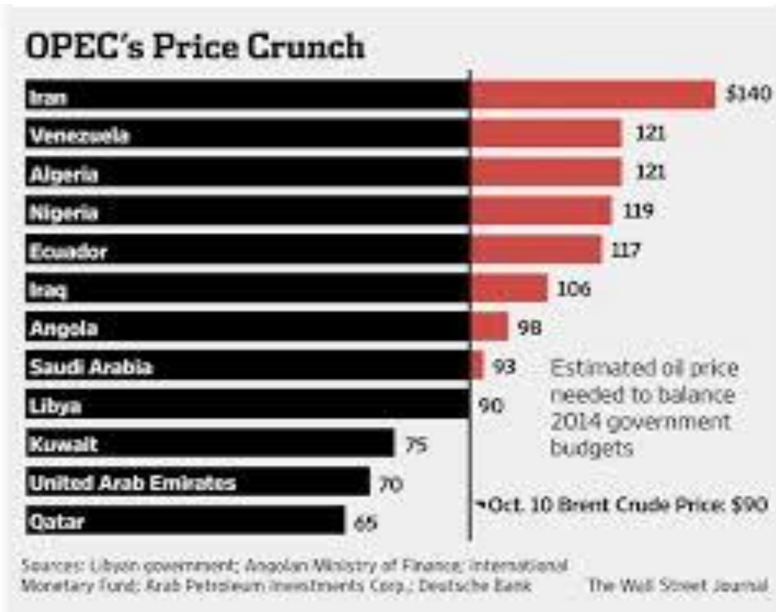
In Russia, where it is rumoured they need $95-105 a barrel to balance their budget; the price drop has cost Putin over $100 billion. The Ruble has collapsed, creating a shortage of imports, his oligarch friends have moved money out of mother Russia, and the pressure is on Putin. The timing is but months after his Ukraine and Crimean forays.

Others think the price drop is a proxy for the Sunni vs. Shia war between the Saudis and much hated Iran, who is facing similar pressures the Russians are facing.

With respect to terrorist organization ISIS, it was reported the bulk of their financing was from $3 million per day sales of black market oil. Well they just took a 50% haircut, and that helps both the Saudis and Americans.

Similarly, Venezuela has some serious cash flow issues. Now so do Angola, Bolivia, Ecuador and Nigeria. Venezuela, Iran, Iraq and Russia especially cannot balance their budgets and have made enormous political promises to their citizens regarding social programs, energy subsidies, and other programs……which they cannot now pay for.

Absorb the following “break-even” prices needed by various OPEC nations:



Either way, the decision by the Saudis is a huge gamble that can create huge geopolitical risk.

As always, the pundits are now coming out saying the collapse in energy prices is a precursor to a bear market in stocks, but historical facts do not back up that claim. According to Bespoke Research, the S&P 500 averaged a +3.02% return and gains 2/3 of the time when oil was in a bear market.

The current “bear market” in crude oil is at about 440 days, the second longest in the past 30 years (the longest was 541 calendar days from June 1992 to December 1993), so once tax loss selling is out of the way in the next week or so, energy names may start to see a bottom. The energy sector is still about 8% of the S&P 500 market cap, which is still high when compared to the 1980’s and 1990’s.

The biggest concern in my mind is the collapse in energy prices adding to the deflationary cycle concerns, and may even result in a negative inflation numbers in 2015. I don’t think so, but something to keep an eye on. It is important to note though, if we are going to experience any form of deflation, energy deflation is the best kind since lowers manufacturing input costs, and as mentioned earlier, should add to consumer disposable income. Confirmation of this are the recent higher moves in fast dining stocks, and retailers, indicating consumers may be venturing back out.

Stay tuned,

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